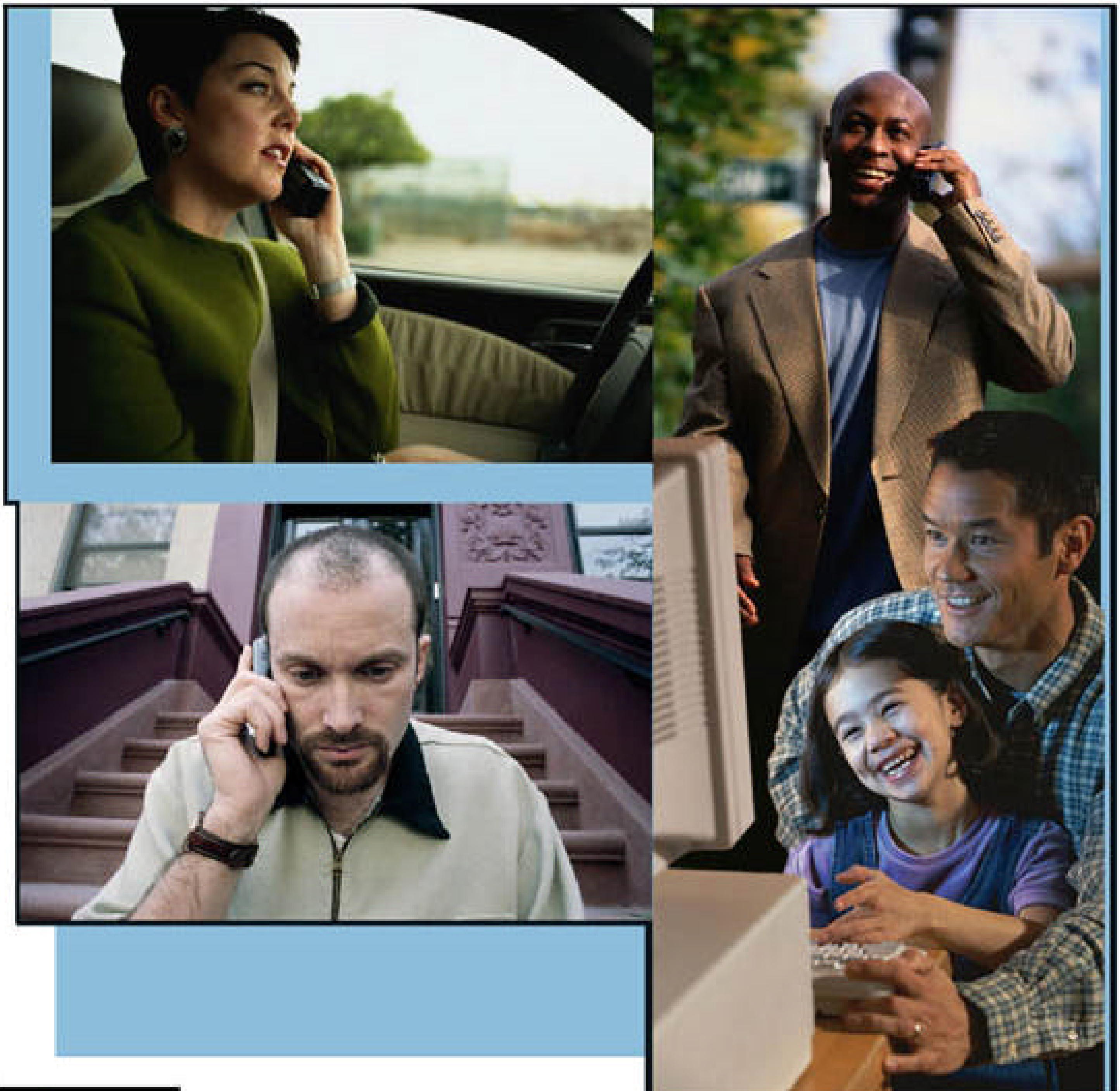
Consumer Perspectives on Universal Service:

June 2003

Do Americans Lose Under a Connection - Based Approach?



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Preface

This report is a project of the New Millennium Research Council (NMRC), established in 1999 to foster policy research focused on developing workable, real-world solutions to the issues facing policymakers, primarily in the fields of telecommunications and technology. The Council consists of independent academics and researchers who are experts in their fields. Both seated experts and invited scholars author NMRC reports.

During the past year, the NMRC has investigated a range of issues related to competition in the telecommunications industry. The NMRC has also sponsored a number of roundtable events in Washington, D.C., and legislative briefings on various topics.[1]

In this report, the NMRC continues its investigation of telecommunications policy issues by examining recent Federal Communications Commission (FCC) proposals on how to maintain a sustainable, long-term Universal Service Fund (USF) as required by Section 254 of the Telecommunications Act of 1996 ('96 Act or the Act).

This report presents the views of six telecommunications experts – ranging from an economist to advocates for consumers, rural communities, and older Americans – who in their own unique voice offer insightful perspectives on existing and proposed USF funding mechanisms and whether to retain, modify, or abandon the current revenue-based USF funding scheme.

The report's authors consider the effects of the FCC's proposals to change the carrier contribution methodology from the current revenue-based assessment system to a flat fee connections-based system. They examine whether this proposed shift is a workable solution to achieve the FCC's congressionally mandated goals in Section 254 of maintaining a "specific, predictable, and sufficient" USF funding mechanism and "ensuring the delivery of affordable telecommunications services to all Americans." In addition, they assess the proposed changes and whether they comply with the requirement that the contribution methodology be administered on an "equitable and nondiscriminatory basis."

The NMRC publishes this report at a very important crossroads for the telecommunications industry. The industry as a whole has weathered a depressed economy and the FCC, in turn, has had to grapple with a host of vexing issues relating to competition, broadband, and universal service. The outcome of the FCC's outstanding proceedings, including the review of the USF assessment method, will impact the industry for many years to come.

The New Millennium Research Council wishes to thank the authors for their time and insight on this critical and timely issue.

June 2003

[1] See our website at www.newmillenniumresearch.org for copies of the reports and transcripts of prior events.

Author Biographies

The six noted experts that contributed to this report represent a broad cross section of perspectives. They are:

James A. Bachtell is currently a Staff Attorney with the Institute for Public Representation, a public interest law firm and clinical education program founded by Georgetown University Law Center in 1971. He received his J.D. in December 2001 from the University of Iowa College of Law, graduating with distinction. Mr. Bachtell also holds an M.S. and a B.S. in Journalism and Mass Communication from Iowa State University. While a law student, he was a student intern in the Legal Clinic and a member of the Law Review. He clerked during the summer of 2001 for Foulston & Siefkin, L.L.P. in Wichita, Kansas. After graduation, Mr. Bachtell worked at the Law, Health Policy and Disability Center in Iowa City, Iowa. Prior to attending law school, he was a Reporter and then Managing Editor for the Boone News-Republican, in Boone, Iowa.

Matthew D. Bennett is Policy Director of the Alliance for Public Technology (APT), a non-profit membership organization concerned with fostering access to affordable and useable information services and technologies to all people. He educates and advocates for policies that expedite the deployment of advanced telecommunications services to all sectors of society, working with and establishing coalitions to spur involvement in telecommunications issues. Before joining APT, Mr. Bennett served as Senior Associate for Communications and Government Relations at the Alliance for Community Media.

Mark Cooper is Director of Research at the Consumer Federation of America where he has responsibility for energy, telecommunications, and economic policy analysis. Dr. Cooper has published numerous articles on telecommunications and the media in trade and scholarly journals including recent law review articles on digital society issues. Dr. Cooper is also Director of the Digital Society Project, a Ford Foundation-funded effort to analyze and explain the impact of ongoing technological changes in American society to consumer, low income, and civil rights activists and organizations. He holds a Ph.D. from Yale University and is a former Yale University and Fulbright Fellow. During 2002-2003, Dr. Cooper is a Fellow at the Stanford Law School Center for Internet and Society and an Associated Fellow at the Columbia University Institute on Tele-Information.

Larry F. Darby is President of Darby Associates, a research firm based in Washington, D.C. He focuses on issues of information technology, telecommunications, and industrial organization. Dr. Darby concentrates on policy implications of developments in broadcasting, cable TV, telephony, trade and technology, and common carrier regulation. He has also served as senior economist in the White House Office of Telecommunications Policy and as chief economist and chief of the FCC's Common Carrier Bureau. Dr. Darby received a Ph.D. in economics from Indiana University.

Jeffrey Kramer is Senior Legislative Representative in the Federal Affairs Department of AARP. He represents AARP on utility, telecommunications, death care, and consumer fraud issues. Prior to joining AARP in 1997, Mr. Kramer was the Manager of Political Affairs at the Edison Electric Institute for nine years. At EEI he represented the electric utility industry on Capitol Hill and within the Executive Branch. A native of Brooklyn, New York, Mr. Kramer received his B.A. in American Government from the University of Virginia and his J.D. from George Mason University. He is a member of the Federal Communications Bar Association and was recently reappointed to a second term on the Consumer Advisory Committee at the FCC.

Leroy Watson is Director of Legislative Affairs for the National Grange. His primary areas of government relations expertise are in rural healthcare, rural public safety, rural education, rural telecommunications issues, environmental policies affecting agriculture, and state-level grassroots education and information initiatives. Mr. Watson received a law degree from George Mason University School of Law and a B.A. in Political Science from the University of Vermont in Burlington.

Executive Summary

The authors examining the FCC's proposed changes to the USF funding mechanism conclude that there are several basic problems with the three proposals now under consideration at the FCC for flat fee connections-based assessment models for universal service contributions. Bachtell, Bennett, and Darby do not see a need to change the current system, but recommend adjustments to the revenue-based scheme as telecommunications competition evolves. Cooper, Kramer, and Watson agree that low-volume, low-income, and rural residential customers would be unduly harmed by bearing a disproportionate share of the burden while enjoying few of the benefits. In addition, Bennett, Cooper, and Kramer warn that a connections-based system would inequitably shift costs between different groups of carriers contrary to current law. Finally, all authors conclude that end-user revenues are the best measure for assessing contribution amounts, even if that is expanded to intrastate revenues, and eventually, to broadband services.

➤"If it ain't broke, don't fix it!"

While the current revenue-based system offers opportunities for carriers to "game" the system, there are fairly reliable checks on the accuracy of reported revenues, according to Larry F. Darby, President of Darby Associates. Dr. Darby warns that counting connections or sharing responsibility between access providers and transport providers "opens up new, and unknown, opportunities for gaming and tax avoidance." In order for the FCC to justify a departure from the current system, it must answer the critical questions of the new scheme's relative efficiency, flexibility, and administrative costs, he says.

"The good news is there is no need to throw out the current revenue-based system," says James A. Bachtell, Staff Attorney at Georgetown's Institute for Public Representation (IPR). Mr. Bachtell contends that the FCC's interim measures adopted in February 2003 will sustain the USF until at least 2007. "By increasing the wireless safe harbor, the FCC remedied the largest universal service assessment problem—wireless carriers' disproportionate contribution to the USF." Beyond that, Mr. Bachtell advances the proposition that the FCC could move to an "all-revenue" plan. "The modifications made to the current system should be given the opportunity to work," he says.

Adopting a new "connection tax" to fund the USF would be a drastic change, according to Leroy Watson, Director of Legislative Affairs for The National Grange. "Instead the fundamental structure of the current revenue based methodology for assessing USF contributions, based on the 'user pays' principle should be maintained," he says.

➤Low-volume, low-income users would be disconnected with a connections-based fee by paying a disproportionate amount into the fund.

"Under some of the proposed funding mechanisms, these low-volume long distance service callers would be required to pay the bulk of the funding for Universal Service," says Jeffrey Kramer, Senior Legislative Representative for AARP. The group estimates that some 40% of consumers fall into the low-volume category. "Ideally, all consumers should see their monthly USF charges decline to $.00 through a system that would allow carriers to recover their cost in rates as a legitimate cost of business," he says. "The move to a per-line charge some are considering would be harmful to the very population the fund seeks to help and should not be adopted."

For Mr. Bachtell of IPR it's a matter of "consumer parity." He says, "adopting a regressive, connections-based methodology would have serious implications for those who can least afford it—the low-income and the elderly." The three connections-based proposals would result in much higher USF charges for low-volume users and shift a larger portion of the USF assessments onto residential customers and away from businesses, he says. This shift could cause low-income and low-volume users to drop their phone service and contradicts the FCC goal of increasing telephone subscribership, he adds.

Although a connections-based fee would treat all consumers "equitably" on its face, not all telecommunications users are the same, says Matthew D. Bennett, Policy Director for the Alliance for Public Technology (APT). "Subjecting them to the same rules benefits the high end users while disproportionately burdening those with lower incomes."

Mr. Bennett says that universal service has traditionally been based on a model of high-volume users subsidizing low-volume users and a connections-based mechanism would be contrary to this basic precept. “Universal service cannot harm those citizens it was created to assist,” he says.

➤A connections-based mechanism shifts costs from one group of carriers to other groups of carriers.

The proposed connections-based approaches are unlikely to conform to the requirements of an equitable, nondiscriminatory and competitively neutral mechanism, APT’s Mr. Bennett writes. “Instead of balancing the contributions among various providers, the connections-based model simply allocates the costs differently among the providers,” he notes. The current system is still the most balanced option because the combination of assessing interexchange revenue and the subscriber line charge (SLC) meet the Act’s principles of universal service.

“Counting each dial-up connection, wireless connection, and high speed Internet connection, as well as larger trunk lines for businesses is not as simple as it sounds,” says Mark Cooper, Research Director for the Consumer Federation of America (CFA). “Since the distinction between local and long distance has been blurred by technology and business practices, [consumer advocates] argue that all services should be included,” says Dr. Cooper. He notes that with a much larger revenue base, the tax rate could be reduced and the controversy would die down.

Mr. Kramer notes that AARP supports increasing the wireless safe harbor to better capture the true percentage of wireless long distance calls made. “This system should be maintained so that carriers can assign the percentage recovery equitably preventing residential consumers from being further disadvantaged,” says Mr. Kramer.

➤End-user revenues continue to be the best measure for assessing universal service contributions.

A modified revenue based methodology is the most reasonable alternative for funding the USF, according to Mr. Watson of The National Grange. “This approach will result in the fewest disruptions in the long standing relationships among various companies and their consumers and will preserve the competitive aspects of the current assessment system.” Mr. Watson also says the current system “deserves to be recognized as the most equitable, least discriminatory, and least market intrusive” way to collect USF contributions from carriers. Incremental changes can be implemented to correct inefficiencies or inequities, he adds.

“An all-revenue plan would resolve the intractable problem of determining whether income is derived from intrastate or interstate sources, especially as wireless, bundling, and Internet telephony increase in popularity,” says Mr. Bachtell of IPR.

“Counting connections instead of usage of the network has the effect of shifting the burden from large volume users to low volume residential users,” CFA’s Dr. Cooper says. “It’s not surprising that consumer advocates prefer an approach that continues to rely on usage, but pulls in more revenues,” he says.

“In short, the FCC’s reasons for seeking to replace the current scheme are not compelling and appear to have little merit,” says Dr. Darby. “It is possible to ‘mend’ current deficiencies in the revenue-based scheme well short of simply abandoning it in favor of another scheme – connections – which may be even more fundamentally flawed,” he says.

Contributing authors to this report generally conclude that moving to a connections-based funding scheme would not meet the ’96 Act’s twin goals of an equitable and sufficient funding mechanism and ensuring affordable telecommunications services for all. They conclude that a connections-based system would discriminate against low-income and low-volume users, rural residential users, and older Americans, who they say would pay a disproportionate amount for universal service. While the current revenue-based system could use some reform and will face new challenges, especially as broadband moves forward, it is the best alternative to sustain the USF now and going forward in the rapidly evolving world of telecommunications.

Background: The FCC and Universal Service

The assessment and recovery method for carrier contributions to the Universal Service Fund (USF) was established in the '96 Act. Section 254 of the Act instructed the FCC to establish USF contribution methods for providers of interstate and international telecom services to ensure affordable telecommunications service to all Americans, including low-income and high-cost consumers, eligible schools and libraries, and rural healthcare providers. Section 254 also required all telecom carriers to "contribute, on an equitable and nondiscriminatory basis, to the specific, predictable, and sufficient mechanisms"[2] established by the FCC.

In May 1997, the FCC concluded that USF assessments based on end-user telecommunications revenues should be competitively neutral, easy to administer, and would eliminate some economic distortions associated with assessing gross telecom revenues. The FCC declined to adopt a mandatory end-user surcharge to collect contributions because it did not want to dictate how carriers recovered their USF contribution obligations and possibly affecting carriers' flexibility to offer bundled services or new pricing options, the FCC reasoned.

Instead, the FCC allowed carriers to decide for themselves whether, how, and how much to recover from their customers. But carriers couldn't "shift more than an equitable share of their contributions to any customer or group of customers,"[3] and they had to provide complete information about the USF charge.

In May 2001, the FCC sought to streamline and reform both the way it assessed carrier contributions and how carriers were allowed to recover these costs from their customers. The FCC asked for views on the current revenue-based assessment system and alternative approaches, such as assessments based on a flat fee. The FCC cited changes in market conditions, declining interexchange carrier revenues, the growth of wireless and Internet-based technologies, and the "bundling" of local and long distance services for its fresh look at USF funding.

In February 2002, the FCC sought comment specifically on whether it should assess contributions based on the number and capacity of connections instead of interstate revenues (e.g., a flat fee per line on residential users, a fee based on number and capacity of connections for businesses). The FCC also asked if it should require carriers to make the USF line item uniform for all their customers and if it should prohibit carriers from recovering amounts in excess of carriers' actual USF contributions.

In December 2002, the FCC adopted several interim measures designed to make the current contribution system more equitable while it continued to consider alternative long-term solutions. The FCC sought information on three specific connections-based approaches: a flat charge for each end-user connection based on the nature or capacity of the connection, an assessment on capacity only with the contribution obligation shared between access providers (local exchange carriers) and transport providers (interexchange carriers), and an assessment based on working telephone numbers.

At the same time, the FCC increased the wireless "safe harbor" from 15% to 28.5%, which increased wireless carriers' contributions to USF. The FCC also began basing USF contributions on projected, collected end-user revenues instead of historical, gross-billed revenues and prohibited carriers from including a mark-up above their USF contribution factor if they chose to recover those contributions through a line item on consumers' phone bills.

In May 2003, the state members of the Federal-State Joint Board on Universal Service (Joint Board), which had originally supported a connections-based system, reversed their view and recommended that the FCC continue to rely on telecom revenues for assessing USF obligations.[4] The Joint Board also recommended expanding the revenue base to include "nearly all forms of telecommunications" and joined with their FCC colleagues to seek legislation to allow the FCC to include intrastate revenues in the USF assessment and contribution equation.

[2] 47 U.S.C. § 254(d)

[3] *Universal Service Order,* 12 FCC Record 8776 at 9199, ¶829 and 9211, ¶855

[4] Letter from G. Nanette Thompson, State Chair of the Joint Board, to Marlene H. Dortch, Secretary, Federal Communications Commission, filed May 20, 2003 (*Second Ex-Parte Recommendation).*

A Matter of Parity: Consumers Lose with a Connection-Based Approach

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The Federal Communications Commission ("FCC") is currently determining whether it should fundamentally alter the way it collects universal service funding from carriers and, as a consequence, how this cost will be passed on to customers. The proposals under consideration would disproportionately affect low-income and low-use consumers. Rather than adopt any of the connections-based proposals, consumers would be better served in the short term by retaining the current system as recently modified and, over the long term, by expanding the pool of revenue assessed to include all telecommunications revenue.

A Threat to Those Who Can Afford it the Least

Amid the complicated and technical arguments in the debate over how carriers should contribute to the universal service fund ("USF") is the simple matter of consumer parity. Under the current revenue-based system, everyone paying a telephone bill contributes to the USF based on a percentage of his or her particular long-distance charges. Under the proposed connections-based methodology, however, a flat fee would be assessed on every customer, regardless of how many long distance calls the customer makes.

Adopting a regressive connections-based methodology would have serious implications for those who can afford it least—the low-income and elderly. There is a direct correlation between income and long-distance telephone usage. Households making less than $10,000 a year use long-distance services half as much as those households making more than $70,000.[1] Seniors also make fewer long-distance calls, with people over 65 generating roughly half the number of weekly long-distance calls as those under 65.[2]

This means that a connections-based methodology would require the low-income and elderly—the customers that contribute the smallest amount of telecommunications activity or revenue—to subsidize price reductions for customers who are better able to afford long-distance service.

Background

The goal of universal access to telephone service dates back to the 1934 Communications Act. In the Telecommunications Act of 1996, Congress established the principle that all consumers, including the low-income and those in rural and high cost areas, should have access to telecommunications and information services. The primary means by which the FCC ensures that low-income consumers have access to these services is through the Lifeline program, which subsidizes local telephone service, and the Linkup program, which subsidizes telephone hook-ups. The 1996 Act also provides subsidies for advanced telecommunications services for qualified schools, libraries, and rural healthcare providers. The Act further provides that the funding for these subsidies should be "specific, predictable and sufficient" and that all providers of telecommunications services should make an equitable and nondiscriminatory contribution.

In carrying out the 1996 Act, the FCC determined that each carrier's contribution to universal service would be based on its end-user telecommunications revenues. This cost could then be passed on to consumers, either through their

[1] Florida PSC Survey; Bureau of Labor Statistics, *Consumer Expenditure Survey: 1997*; The Yankee Group, *Understanding Consumer Spending on Communications*, Dec. 1999.
[2] Christopher A. Baker & Ann McLarty Jackson, Public Policy Institute, *Consumer Pricing Practices and Savings Opportunities in the Long Distance Telephone Industry: Findings from an AARP Survey,* Figure I.2 (2000).

rates or as a separate line item.[3] The FCC initially planned to assess carriers' intrastate and interstate revenues to fund certain USF services. After the Fifth Circuit Court of Appeals found that the agency lacked jurisdiction to assess intrastate revenue, the FCC adopted a contribution base relying mainly on interstate revenues.[4]

Determining each carrier's contribution based only on interstate revenues generated problems as new technologies and innovative billing options made it difficult to determine what revenue legitimately belonged in the universal service pool. Cell phone companies, local carriers, and Internet telephony providers began offering plans that bundled local, long-distance, and other services for one rate—blurring the distinction between what constituted intrastate and interstate revenue. In response, the FCC adopted a "safe harbor" that permitted cell phone providers to contribute to the USF based on an assumption that a maximum 15% of their traffic was interstate.[5] It became clear, however, that the actual interstate revenue from wireless carriers exceeded the safe harbor, a problem exacerbated by the disproportionate growth of wireless revenue in the telecommunications marketplace.[6] Consumers were also subject to carrier "mark-ups" that increased the contribution factor on their long-distance calls dramatically. The FCC decided to revisit its contribution methodology and sought comment in December 2002 on three connection-based plans—one that would assess some carriers a flat-fee for every connection provided; a plan that would assess all end-user connections on the basis of connection capacity; and a plan that would assesses telecommunication providers' USF contributions on the basis of the telephone numbers assigned to the providers' end users.

Connections-Based Plans Would be Costly to Low-Income Consumers

Besides being regressive and inequitable, the three connections-based proposals will result in much higher USF charges for low-use consumers. The FCC estimated that even the average-use long-distance consumer could be paying $1.26 more per month under one connections-based plan.[7] Moreover, all three proposals shift a larger proportion of the USF assessments onto residential customers and away from businesses.[8]

Increasing USF costs for low-volume consumers would have important implications in maintaining current telephone subscribership levels, especially among the low-income and elderly. While nearly 96% of all Americans have telephone service, the penetration rate for low-income households is 89%.[9] When families face difficult economic times, social service workers note that telephone service is often the first thing that is cut.[10] Considering the current difficult economic conditions, an increase in monthly charges is likely to force many to drop their telephone service. Not only would this affect the health and welfare of many individuals and families, it is contrary to the 1996 Act requirement that quality telecommunications services be made available at just, reasonable, and affordable rates.[11]

[3] *Federal-State Joint Board on Universal Service*, Report and Order, 12 FCC Rcd 8776, 9206-07 (1997).
[4] International end-user revenue is also included. *See Federal-State Joint Board on Universal Service*, *Access Charge Reform*, Sixteenth Order on Reconsideration and Eighth Report and Order in CC Docket No. 96-45 and Sixth Report and Order in CC Docket No. 96-262, 15 FCC Rcd 1679, 1685-86 (1999).
[5] *Federal-State Joint Board on Universal Service*, Memorandum Opinion and Order and Further Notice of Proposed Rulemaking, 13 FCC Rcd 21252 (1998).
[6] Between 1996 and 2001, wireless revenues grew by more than $50 billion, compared to the $7 billion growth in long distance carrier revenue. Industry Analysis and Technology Division, Wireline Competition Bureau, *Trends in Telecommunications Service* (Federal Communications Commission, May 2002), Table 16.4.
[7] *Commission Seeks Comment on Staff Study Regarding Alternative Contribution Methodologies*, CC Docket No. 96-45, FCC 03-31 (rel. Feb. 26, 2003) ("*Staff Study*").
[8] *Id.*
[9] FCC, *Telephone Penetration by Income by State***,** Industry Analysis and Technology Division, Wireline Competition Bureau, 1 (rel. May 2003).
[10] Jeff Eckhoff, *20,000 Households in Iowa Phoneless*, Des Moines Register, Nov. 25, 2002.
[11] 47 U.S.C. § 254(b)(1).

A Matter of Modification, Not Replacement

While adopting a connections-based system would be harmful to many—if not most—consumers, the good news is there is no need to throw out the current revenue-based system. To ensure the USF's long-term stability and sufficiency, the FCC recently modified the current contribution methodology by increasing the wireless safe harbor from 15% to 28.5%, eliminating carrier mark-ups on USF assessments, and taking other measures to ensure its sustainability. By increasing the wireless safe harbor, the FCC remedied the largest universal service assessment problem—wireless carriers' disproportionate contribution to the USF. This move alone should ensure that the USF remains sustainable.[12] While these changes are considered interim measures, the FCC has shown in a staff study that the improvements will sustain the fund and keep USF assessments affordable for consumers until at least 2007.[13]

The Future: Calling on a Broader Pool of Revenue and Contributors

While the current interstate revenue-based model will sustain the USF for the foreseeable future, a better approach for the long term would be to assess carriers on the basis of *all* revenue, not just the income derived from long distance sources.

An all-revenue plan would resolve the intractable problem of determining whether income is derived from intrastate or interstate sources, especially as wireless, bundling, and Internet telephony increase in popularity. Not only is this good policy, it better accomplishes Congress's goal of ensuring a "specific, predictable and sufficient" mechanism for advancing universal service.[14] Even without action by Congress, the FCC can successfully assert jurisdiction over intrastate revenue under the "impossibility exception" doctrine.[15]

Furthermore, an all-revenue system ensures that quality service is available at just, reasonable, and affordable rates. By keeping a revenue-based system, the inequities of a connections-based approach are avoided. An all-revenue approach would also be much simpler to administer than the current interstate methodology and would distribute the USF burden over a broader base of revenue, keeping consumer contributions down.

Finally, in conjunction with broadening the pool of revenue it collects from, the FCC should also consider expanding the pool of contributors to include such services as broadband and Internet telephony. This would also spread the burden and further reduce the hardship on consumers.

Conclusion

A new USF contribution methodology is not needed. The additional burden of a connections-based system would result in many low-income and elderly Americans dropping their telephone service. The modifications made to the current system should be given an opportunity to work. Then, if the need for universal service funds continues to outpace the supply, an all-revenue approach should be considered that broadens the base of available funds and contributors.

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[12] Two studies confirm this. *See* Comments of CU *et al.*, CC Dkt. No 96-45, filed Feb. 28, 2003, attached affidavit of Dr. Mark N. Cooper; Comments of TracFone Wireless, Inc., CC Dkt. No. 96-45, filed Feb. 28, 2003, attached analysis of Henry B. McFarland, Economists, Inc.

[13] *Staff Study.*

[14] 47 U.S.C. § 254(b)(5).

[15] This exception was first recognized in *North Carolina Util. Comm'n v. FCC*, 537 F.2d 787 (4th Cir. 1976).

Preserving the Noble Effort: The Search for Universal Service Equity

Matthew D. Bennett
Policy Director
Alliance for Public Technology

Technology changes and other external factors have placed the universal service system in a state of flux. The current contribution mechanism of assessing the interstate revenues of carriers has weakened and is in danger of being unable to meet the obligations of the universal service support programs. The contribution framework must not only be fixed for today's needs, but also so the system can evolve with the rapidly expanding telecommunications world and embrace new technologies, such as broadband, when they meet the universal service support criteria. Without improvement, universal service could face severe funding shortfalls, creating dangerous inequities in consumer access to telecommunications and hindering the noble effort to provide telephone service to all Americans at reasonable rates.

The challenge for universal service is the establishment of a contribution methodology that would provide sustainable funding for the system as the telecommunications industry moves from the traditional wireline model to a more complicated environment. Today, the differences between local and long distance traffic are much more difficult to define, data transport over non-telephony systems is growing, IP telephony and other non-traditional systems not covered under the universal service definition present new obstacles, and substitution technologies such as e-mail and instant messaging are reducing the amount of use of the traditional telephone network. Whatever reforms are enacted to improve the contribution side of universal service must also be prepared to answer even greater questions as broadband becomes more prevalent and enters the universal service sphere.

The contribution methodology must be broad based and inherently fair. The current system has some shortcomings and needs reform to ensure equity, but it is still the most balanced option. The combination of assessing interexchange revenue and the Subscriber Line Charge (SLC) adheres to the principles of universal service set forth in the Telecommunications Act, which requires an equitable, nondiscriminatory and competitively neutral mechanism.

The proposed connections-based approaches are unlikely to ever conform to these parameters. The FCC's staff study on the proposed modifications shows that instead of balancing the contributions among various providers, the connections-based model simply allocates the costs differently among the providers. The connections-based approach does treat all consumer users in the same fashion for contribution purposes. While this meets a basic definition of "equitable," all telecommunications consumers are not the same, and subjecting them to the same rules benefits the high end users while disproportionately burdening those with lower incomes.

Universal service has always been based on a model of high volume users subsidizing low volume users. The connections-based mechanism is contrary to this history. Instead of seeking higher fees from businesses and other large-scale users, the flat fee per connection would charge universal service fees to a customer with 20 lines and a T1 connection in the same manner as a low-income user who might only make a few phone calls per month. A per connection charge is a higher percentage of an individual's telephone bill for someone who pays ten dollars per month than someone who pays one hundred dollars per month.

Within the current revenue system, the contribution factor is approximately 9%, meaning the customer with a ten-dollar phone bill for interexchange service currently faces a universal service charge of ninety cents and the customer with a one hundred-dollar phone bill for interexchange service must pay nine dollars. The current revenue system is, therefore, more equitable than a flat connection charge of one dollar (as cited as an example in the FCC's Second Further Notice of Proposed Rulemaking), which would raise the contribution of the low volume user while reducing the burden on high volume users.

Universal service cannot harm those citizens it was created to assist. Shifting the cost burden to these consumers would violate the spirit of universal service. The revenue based contribution methodology, with adjustments such as those already put in place by the FCC, remains the most equitable formula and should be maintained.

Another key element of the universal service debate is preservation of the public switched network. Depending on the definition of connection, providers could move away from traditional voice services and toward alternate technologies that are not subject to universal service assessment. This could do great harm to the network. Should the network's integrity erode, the platform for future advanced services will be severely limited.

Universal service must be sustainable and also prepared to move forward in the rapidly evolving world of telecommunications. In the near future, universal service will have to address the question of broadband, which is currently muddled in the system. Digital subscriber line (DSL) services provided by telephone companies are assessed for universal service contributions, but other forms of broadband such as cable modems are not. No forms of broadband are currently eligible for universal service support to lower costs for consumers or provide assistance to carriers in serving remote communities. How would a connection-based assessment approach affect this situation?

In the future, broadband is likely to meet the criteria in the Telecommunications Act and be eligible for universal service support, at which time the universal service system will face a strain far greater than the problems of today. Would the connection model still generate enough funding for universal service, when the demands will grow larger as providers will have to build expensive broadband facilities to serve remote areas? These questions must be answered before a connection-based model is accepted.

Universal service is a pillar of telecommunications policy. Reforms must be considered carefully, with great attention paid to how those reforms would affect the underserved communities that have been promised service. In this case, the connection-based contribution reform would greatly undermine this promise, by asking the vulnerable citizens to practically subsidize themselves. It is also an unknown quantity as it relates to the future of the fund and the inclusion of broadband. The revenue-based model is still the best mechanism for collecting funds in an equitable manner while protecting consumers who depend on the universal service fund and its noble intentions.

Universal Service: A Constantly Expanding Goal

Mark Cooper
Research Director
Consumer Federation of America

A commitment to universal service was at the center of American telecommunications policy for almost the entire twentieth century. It started in the first decade of the century, when Theodore Vail, President of AT&T articulated a vision for the telephone network.

> "One system, with a common policy, common purpose, and common action; comprehensive, universal, interdependent, intercommunicating, like the highway system of the country, extending from every door to every other door, affording electrical communication of every kind from every one and every place to every one at every other place."

The Communications Act of 1934 made it explicit government policy, when Congress adopted a goal that "sought to make available to all people of the United States, a rapid, efficient, nation-wide, and world-wide wire and radio communications service with adequate facilities at reasonable charges."

The goal reappeared in the largest rewrite of the 1934 Act, when section 254 of the Telecommunications Act of 1996 articulated seven principles for universal service, the first of which was "quality services should be available at just, reasonable, and affordable rates."

The Telecommunications Act of 1996 carried the process one step further. With respect to service it made very bold and detailed demands. It required that "consumers in all regions of the nation including low income consumers and those in rural, insular and high cost areas should have access to telecommunications and information services… that are reasonably comparable to those services in urban areas and that are available at rates that are reasonably comparable." It added a large program for schools and libraries as well as rural health care.

The Continuous Debate Over Funding

The consistency of the goal of universal service has been matched or exceeded only by the continual bickering over how to pay for it. During decades of the virtual Bell system monopoly, universal service was funded through internal transfers and state ratemaking. The formula for allocating costs between the federal and state jurisdictions was the subject of constant wrangling at the Federal Communications Commission and in lawsuits.

With the break-up the Bell system in 1984, some of the burden of universal service became explicit. The federal government adopted a lifeline and link-up program for low income households. A high cost fund for rural areas grew. A subscriber line charge was placed on the bottom of the telephone bill to take some of the pressure off of long distance rates, which a quarter of the cost of the network had been recovered.

On the funding side, the Congress did not leave it to the FCC and the industry, declaring that "there should be specific, predictable and sufficient federal and state mechanisms to preserve and advance universal service." The Act also added language that "all providers of telecommunications services should make an equitable and nondiscriminatory contribution to the preservation and advancement of universal service."

The Act left the Commission to work out the details. The administrative proceedings and lawsuits began almost before the ink was dry on the new law.

Growing Pressures on Universal Service Funding in a Competitive Era

The underlying issues confronting universal service in the past century have not changed, but have been intensified by a combination of increasing expenditures, technological change and increasing competition.

In 1996, before the lifeline programs triggered by the Telecommunications Act, the high cost program, targeting assistance at primarily rural areas, and the lifeline program, targeting assistance at low income households, totaled somewhat less than $7 billion per year. In 2001, these programs combined with the new schools and library program and the rural health care program, intended to ensure that advanced telecommunications services were available in important critical community institutions, exceeded $11 billion.

Revenue in the industry has been growing as well. Local revenues increased from about $110 billion in 1996 to over $130 billion. Long distance grew much more slowly, increasing from $87 billion to $94 billion. Wireless was the big growth area, tripling from $26 billion to $76 billion. The slow growth in long distance reflected a combination of factors. Competition kept rates down for high volume residential and business customers. Wireless became a substitute for long distance service as its prices fell. Growth in long distance may also have been slowed by the spread of e-mail.

On the surface, it would appear that the burden of universal service costs were growing only slightly faster than revenues, up from 3 percent to 3.8 percent. However, following the long standing tradition, the courts concluded that the long distance revenues provided the base for funding universal service. Local revenues are not included in the base because the program was deemed to be federal.

At the same time, the FCC had trouble dealing with wireless revenues because the industry claimed it could not distinguish between local and long distance calls. At the start of 1996, the wireless industry was young and regulators hesitated to impose a burden. Rather than try to sort it out, or impose the costs of measurement on the industry, it declared a safe harbor in which 15 percent of the segment revenue was considered to be for universal service assessment.

Current Controversies

E-mail and cellular pressure the long distance market on the revenue side, yet neither conforms to the traditional distinction between local and long distance. As competition for local service increases, even local companies have offered bundles of minutes of telephone service that make no distinction between where the calls go.

Two sources of pressure continue to flow from the funding for the program. First, the base is shrinking, relative to total size of the industry and the growing costs of universal service. Second, because some services pay, while others do not, various sectors complain that the funding mechanism is not competitively neutral. The FCC's interim reaction was to increase the share of wireless revenue included in the universal service pool to 28 percent, but pressures from the industry for further reform continue.

The simplest solution, from the industry's point of view, it to just shift the universal service charges to the consumer on the basis of the number of connections they have to the telephone network. This is simple and eliminates the competitive gaming caused by differential treatment of services. Counting each dial-up connection, wireless connection and high speed Internet connection, as well as larger trunk lines for businesses is not as simple as it sounds. Several different approaches have been suggested.

Counting connections instead of usage of the network has the effect of shifting the burden from large volume users to low volume residential users. Not surprisingly, consumer advocates prefer an approach that continues to rely on usage, but pulls in more revenues.

The majority of residential customers make a small number of calls each month. By shifting to a connections-based charge, all residential customers bear the same per line burden, regardless of the number of calls. Such a charge amounts to a mandatory monthly charge like a basic rate increase. Under some proposals being considered, the increase could amount to about $1.50 per month per customer.

A flat fee based on connections would raise the charge to a greater degree for low-income and low-volume users and lower the charge for the benefit of high-volume users. Such a charge is not in line with the FCC's own ruling that carriers “not shift more than an equitable share of their contributions to any customer or group of customers.”

Since the distinction between local and long distance has been blurred by technology and business practices, they argue that all services should be included and that the level of use is the best indicator of the benefit derived from the existence of a ubiquitous telephone network. With a much larger revenue base, the tax rate could be reduced and the controversy would die down. Similarly, since all companies and services pay, gaming to gain a competitive advantage would be eliminated.

Future Challenges

As thorny as the issues already are, even greater challenges loom from the Internet on both the revenue side and the benefits side.

On the benefits side, a debate is looming about when to declare universal Internet access a goal of national telecommunications policy. As noted above, the 1996 Act clearly intends for universal availability of information services at reasonable and affordable rates to be the goal. The Communications Act of 1934 adopted the goal of universal service when two-thirds of American households did not have telephone service. The 1996 Act was more timid, stating that “universal service is an evolving level of telecommunications services that… the definition of the services that are supported…shall consider the extent to which such telecommunications services… have through the operation of market choices by customers been subscribed to by a substantial majority of residential customers.” By some counts, Internet access in the home is in the neighborhood of 60 percent.

On the revenue side, Internet telephony could pose a serious challenge. Sending voice telephone service through the Internet, should it ever become widespread, would place immense pressures on industry revenues. To date the role of genuine Internet telephony is quite small because the quality of the voice conversation cannot be guaranteed. Unlike data, which can go in bursts and be cached before it is delivered, human conversations need to flow smoothly.

Growth of Internet telephony challenges the whole notion of a “telephone call” and would shrink long distance revenues. Yet, the Internet relies on the ubiquitous, interconnected telecommunications infrastructure to be effective. If the ten million cable modem subscribers could only talk to themselves, and not the hundred million households and businesses on the telephone network, cable modem Internet telephony would not be very useful.

Starting All Over

Ironically, interconnection was part of the problem AT&T’s initial commitment to universal service was intended (some say cynically) to solve. AT&T made the commitment to universal service in the context of its own refusal to interconnect with independent telephone companies. In exchange for committing to universal service and to ubiquitous interconnection, it got what is close to a national monopoly. Some believe this was a deal with a monopoly devil, but it did produce a darn good telephone network, with a higher level of quality and penetration than most other countries in the world.

The constant hassles over universal service may cause some to despair and demand that the government abandon the issue altogether. By creating a ubiquitous means of electronic communications, we have created a far richer nation. By ensuring that all have access to it, we have created a fairer society. The availability of telecommunications in the twentieth century and advanced telecommunications in the 21st century, binds us together and improves the chances that all consumers and citizens can participate fully in modern life.

Given convergence in the digital information age, electronic communications will be even more central to economic and civic activity in the 21st century than it was in the 20th. The commitment to universal service should be strengthened, not weakened. Policymakers need to take a fresh look at universal service with all of the means of communications and all of the services that rely on a ubiquitous, interconnected network as part of the mix. There are no easy answers to a century old question, but the value of finding practical solutions that keep us moving forward to an ever higher level of universal service is well worth the effort.

Restructuring Universal Service Fund Charges: A Federal Communications Commission Solution in Search of a Problem

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It is hard to argue with the advice in a popular saying: "If it ain't broke, don't fix it!" The Federal Communications Commission (FCC) seems nonetheless inclined to ignore the admonition and replace the current end user revenue basis for assessing payment obligations to the Universal Service Fund (USF) created by Congress in the Telecommunications Act of 1996. It is doing so on the slim reed of finding in the record an "*interest* in a connection-based methodology." Despite an embarrassing lack of analysis of the current scheme as recently modified, and next to no evidence that it is broken, the Commission has clearly signaled a strong predisposition to replace revenue with "connections" as the basis for determining support for USF funded programs.

Background

The 1996 Act attempted to rationalize "universal service" rules for assuring provision of services that for different reasons might not be able to bear their full costs.

Traditionally the tax and subsidy scheme supporting universal service goals has been buried in the structure of rates. Rate structures were designed to hold some charges for some services above costs (the taxed users and uses of the network) so that other services could be provided at rates below costs (the subsidized users and uses). This implicit tax and subsidy scheme evolved over many years and was sustainable in a protected and regulated monopoly environment. The elimination of regulatory barriers, new entrants, and price competition changed all that.

Policy mandated, systematic departure of rates from costs is at odds with the dynamics of market competition. Consistent with long standing theory and business practice, new entrants singled out high margin, subsidy-providing services and shunned subsidy-receiving services that were provided below cost. Competitive pricing pushes rates down toward cost and thereby tends to eliminate subsidy funding sources. Absent offsetting changes, the necessary result will be higher rates for subsidized services.

Congress faced the dilemma of serving contradictory goals – competition and universal service with a single policy instrument – the rate structure. To resolve the conflict, the 1996 Act provided for establishment of a Universal Service Fund to be administered by a new private entity – the Universal Service Administrative Company (USAC). Under rules set by the FCC, USAC was set up to receive payments from carriers and to disburse those to a variety of eligible recipients (high cost carriers, low income users, schools and libraries, as well as for rural health care providers).

Sources of funds for USAC disbursal were defined by Section 254 (d) of the Act which provided that: "...every telecommunications carrier that provides interstate telecommunications services shall contribute, on an equitable and nondiscriminatory basis, to...the mechanism...established to preserve and enhance universal service." The initial FCC implementation of this language resulted in a pro rata assessment on revenues generated by users of interstate telecommunications services (roughly three quarters of the receipts go to schools, libraries, or carriers in rural areas).

The Problem

There are several problems with the FCC's universal service program – some large and some small. The main problem is systemic and resides in the incentive structures reflected in the overall tax and subsidy scheme. Specifically, the demand for cash from claimants on the fund is assured to exceed the willingness of contributors to provide it. The demand for free money is infinite, while the supply is determined by the interplay of the power of the state to tax and resistance of involuntary contributors.

Subsidy recipients (schools and libraries, low income consumers, and rural areas) have powerful political sponsors who back their requests for "more." But, nobody wants to shoulder the tax burdens. The USF is under the same set of political pressures as all government budgets. Congress is now exploring solutions to this larger problem.

Several years ago Senator Russell Long observed that tax reform means, "Don't tax you, don't tax me, tax that fellow behind the tree." So it is with the current initiative at the FCC. It does not address the major problem but instead looks to shift the burden of the universal service tax to folks behind the tree, many of whom are least able to afford the assessment. But, I am getting ahead of the story.

Not surprisingly, cash demands on the USF have increased dramatically. They show no signs of abating. From the first quarter of 1999 through the first quarter of 2003 demands on the fund nearly doubled. Pressures to increase the number of recipients, services covered, and the average draw on the fund will undoubtedly persist.

Over the same period, owing to a combination of technology driven market change and the definition of covered services, the revenue basis defined by the FCC and on which the supporting tax has been levied was down by about six percent. Increasing expenditures combined with a reduced tax basis resulted in steady increases in the "tax rate" (pro rata contribution factor) from 4.95 percent to 8.71 percent in the same four-year timeframe.

While carriers were assessed 8.71 percent of their revenue, they passed along to users an increasing markup over that. The reasons are in dispute, but that aside, it is no wonder the major private sector contributors to the fund – AT&T and other interexchange providers of interstate services – are looking for a way off the hook.

The connections-based alternative scheme of USF charges proposed by AT&T and supported by other interexchange carriers is the source of the FCC's recent solicitation of public comment on the merits of three alternatives to the current interstate end user revenue base for assessing contributions to the universal service fund.

End User Revenues As The USF Tax Base

Winston Churchill summed up the attitude of most taxpayers: "There is no such thing as a good tax!" But, some taxing schemes are better than others. Students of tax and expenditure theory use several criteria to evaluate different tax schemes. Fairness, impacts on economic efficiency, ease of administration, and adaptability to changing circumstances are on most experts' list. Nobody argues that the current base is inequitable, hard to administer, inflexible, inefficient or inherently unresponsive to user and contributor needs.

In prior universal service proceedings, the FCC has emphasized ease of administration and competitive neutrality. It is difficult to imagine any tax base that is easier to administer or, if properly structured, more competitively neutral than the current one the Commission proposes to replace. Notably, the Commission finds no fault with the current scheme on those counts.

Rather, in the current proceeding the Commission cites two threats to the long-term viability of the current, or any, revenue based scheme as the reason for change. The first is that "...interstate revenues are becoming increasingly difficult to identify as customers migrate to bundled packages of interstate and intrastate telecommunications and non telecommunications services." Elsewhere the Commission refers to "market-place developments [that] have blurred the distinction" between contributing and noncontributing services. The second reason given is the decline in the revenue base occasioned by downward rate pressure from competition. Both appear to be excuses for rather than drivers of change.

"Blurring" of boundaries between jurisdictions, services, regulatory schemes, technologies and uses is an almost ubiquitous feature of regulated telecom markets. Changing technology, new players, service innovation, and a battery of other dynamic features of telecom markets undercut definitions and require regulatory adaptation. The FCC has satisfactorily resolved boundary problems in numerous instances involving jurisdictional separations, service cost allocations, divisions between regulated and unregulated services, differentiating broadband from narrowband services, distinguishing interstate from intrastate wireless minutes, and on other occasions.

Regulators have previously resolved numerous boundary questions: What is a telecom service? What is an interstate service? What companies and services will (not) be regulated? How will costs be defined and allocated? In doing so, the Supreme Court has given the FCC latitude and advised that "extreme nicety" is not required.

What about the decline of interstate end user revenues as the basis for changing the tax assessment base? The mere suggestion would be laughable if it, and apparently the Commission, were not so serious. Interstate telecom traffic is growing by leaps and bounds. How then can interstate revenues be declining? There must be a definitional mismatch. Users are shifting from interstate services that are taxed to support the USF to those that are not. Users are shifting from wireline to wireless in making interstate, interexchange calls and they are shifting from traditional "voice and fax" services to Internet based substitutes like email and, to a lesser extent now, VOIP (voice-over Internet Protocol) services.

The Commission suggestion that competition-induced rate reductions represent a threat to the current source of USF contributions will not withstand scrutiny. Relations between revenue changes and rate changes depend on price elasticities around current rates. Using the midpoint of recent elasticity estimates suggests that a ten percent reduction of rates will result in less than a four percent revenue reduction. The amount is not inconsequential, but neither does it indicate, as supporters of the change have suggested, an imminent "death spiral" of the revenue basis for the USF assessment.

Evidence of decline in the USF tax base is traceable in large part to the Commission's treatment of wireless carrier revenue. Under the "safe harbor" provisions in FCC rules, wireless interstate minutes have been substantially undercounted. Thus, as wireless revenues from interstate services grow at the expense of wireline revenues, the shift appears in the data, counterfactually, as a reduction in interstate revenues. Effective in February this year, the amount of wireless revenue safely harbored from USF tax has been reduced from 85% to 71.5%. The result will be elimination of a substantial part of the statistical misrepresentation of the behavior of interstate end user revenues and the disappearance of much of the rationale for abandoning them as the contribution base.

In short, the FCC's reasons for seeking to replace the current scheme are not compelling and appear to have little merit. It is possible to "mend" current deficiencies in the revenue-based scheme well short of simply abandoning it in favor of another scheme – connections – which may be even more fundamentally flawed.

End User Revenues Versus Connections

A full analysis of the relative merits of revenues or connections as the appropriate base for the USF tax would require comparison of each on grounds of fairness, economic efficiency, ease of administration, and adaptability to changing circumstances.

Half measures will have to do here. A quick and dirty application of the teachings of conventional taxation theory and practice turn suggests no basis for preferring connections-based assessments over the status quo.

Some may object that USF assessments are not taxes and therefore traditional tax theory is not relevant. The objection is without merit. Notwithstanding the understandable aversion of regulators to calling the assessment a tax and their insistence that carriers need not pass it through, the fact is that the USF charge is in essential respects identical to an excise tax levied on the sale of any good or service. Traditional tax analysis of the suitability of alternative tax bases and forms is quite appropriate.

Income (corporate or individual) and wealth are, for good reason, the most common bases for taxation. Each tends to be equitable in both a horizontal sense (treating equals as equals) and in a vertical sense (requiring more from those with more ability to pay). As consumer advocates in this series of papers point out, the use of connections-based contributions is not equitable or fair in either sense. In fact, using connections as the basis for assessments to the fund yields a tax that is regressive with respect to the treatment of corporations versus individuals, and with respect to individuals with differing incomes. In both instances entities with lower incomes pay a higher percentage than those with higher incomes. A flat charge for each connection discriminates in favor of those who derive more value from the connection and make greater use of it. Low volume users would be the losers from the change and recent data indicate that low volume users tend to be more elderly and have lower than average income.

The flat rate on connections would also distort the allocation of resources and lead to economic inefficiencies. The extent of such depends on details of implementation not provided in the proposals. Tax avoidance theory teaches that users would find ways to use fewer connections, and avoid private costs of paying connection based taxes, even if the social cost of doing so was significantly higher. Taxing according to capacity or number of connections will decidedly influence user and supplier choices of network configurations and usage bundles. Taxes on connections, capacity, or numbers will lead users and suppliers to economize on those measures of use and without regard to the social cost of doing so. Revenue measures and proportional tax rates finesse these concerns.

More analysis would likely show that the administrative costs of a connections-based scheme will be higher than for a revenue-based scheme. While the revenue number reported can be "gamed" by carriers, there are fairly reliable checks on the accuracy of reported revenue. Counting connections or sharing responsibility between access providers and transport providers opens up new, and unknown, opportunities for gaming and tax avoidance. Similarly, a connections-based scheme is not demonstrably more flexible and adaptable in the face of changing technology, market supply conditions, and user demand.

Conclusion

I have not done the full blown comparative analysis of the alternative tax bases to fund the USF programs. But, neither has the Commission. Nor has it raised these important questions and solicited comment on them. In light of the Commission's weak justification for abandoning the current revenue scheme and the apparent inequities that would accompany the proposed connection-based contribution scheme, it is critical that questions about relative efficiency, flexibility, and administrative costs be evaluated carefully. This is all the more so, since the dominant public interest concern here is the long-term integrity and sustainability of the USF, and the programs it supports, in the context of the inevitable increasing demands on both in the context of technology driven market change.

Preserving the Universal Service Fund

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AARP

AARP has been a strong supporter of the universal service fund, recognizing its importance in providing essential telecommunications services to traditionally underserved communities. We are firmly on record supporting the elimination of surcharges and line items as a means to collect universal service funds. Absent elimination of such charges, however, the existing system of collecting contributions is preferable to the contemplated move to a per-line charge.

AARP has lent its support to the implementation of the Universal Service Fund, particularly the assistance it provides to low-income consumers, since its inception. We have actively promoted the Lifeline/Link-Up programs within the community. In fact, AARP sponsored an event with the Florida Public Service Commission in Tallahassee last year to educate consumers about the two telephone savings programs. Therefore, we have a clear understanding of the need to adequately fund the program.

We believe that a mechanism that levies contributions from every consumer equitably, based on a percentage of the charges assessed for long distance calls, would provide the monies needed to implement the USF without having to make any changes to the existing formula. By "equitably," we mean that special exemptions or preferential rates should not be afforded certain classes of consumers, as is currently the case. The carriers who employ this practice continue to unfairly discriminate against residential consumers, and AARP believes that now is the time to discontinue the practice.

We are concerned that the move to a per-line charge would further institutionalize the universal service line-item charge. Such a change in regulation now would diminish chances of eliminating the per-line charge from consumer's monthly bills, as we have contended it should be in previous filings with the Commission. However, the existing funding mechanism at least does not penalize consumers who make few or no long distance telephone calls. Under some of the proposed funding mechanisms, these low-volume long distance service callers would be required to pay the bulk of the funding for Universal Service. Based on comments filed with the Commission during its review of low-volume long-distance users in 1999, some 44% of consumers fall into this category. While the goal of the Universal Service Fund is to maintain affordable rates for all consumers, this proposal appears to ask those who most need help to provide a disproportionate amount of the funding.

Ideally, all consumers should see their monthly USF charges decline to $.00 through a system that would allow carriers to recover their cost in rates as a legitimate cost of business. AARP believes that the elimination of line-item charges would advance universal service and ultimately benefit more residential consumers. Absent that fundamental shift, however, we support maintaining the existing system of funding the Universal Service Fund based on a percentage of the cost of long distance phone calls a consumer makes.

We also support increasing the "safe harbor" percentage for wireless carriers as a means to better capture the true percentage of long-distance calls. This system should be maintained so that carriers can assign the percentage recovery equitably preventing residential consumers from being further disadvantaged.

In summary, adequate funding of the universal service program is of critical importance. We believe that the move to a per-line charge some are considering would be harmful to the very population the fund seeks to help and should not be adopted. Assessing charges based on use continues to be the most equitable way for low-volume users and consumers in general to contribute to the Universal Service Fund.

The Sky Really Isn't Falling After All

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The National Grange

The role of the Universal Service Fund (USF) for the public good is widely recognized, especially in rural communities. Rural America, where there is an admitted lack of overall communications services, is considered to be on the wrong side of the "last mile" of telecommunications services.

A major reason for the creation of the USF was to achieve parity in telecommunications standards in rural areas that are comparable to the more densely populated metropolitan areas of the United States. Full and fair competition, and compliance with the Telecommunications Act of 1996, is the only way to provide state-of-the-art telecommunications services to rural populations.

However, today a coalition of large long distance telecommunications carriers are trying to use a temporary and correctable funding problem with the USF as an excuse to play “Chicken Littles” and convince the Federal Communications Commission (FCC) to radically shift the burden for funding the USF from the telecommunications industry, which earns a substantial profit by providing lucrative long distance and international phone services, to individual consumers.

The National Grange, the nation’s oldest general farm and rural public interest organization, strongly opposes these “the sky is falling” proposals, including a new telephone “connection tax,” because they will shift the burden of maintaining a full and competitive state-of-the-art telephone and advanced telecommunications infrastructure to individual consumers, especially rural consumers for whom basic phone service is a necessity.

The revenues that fund the USF are generated, by law, from the revenues collected by companies that provide existing telecommunications services. Section 254(d) of the ’96 Telecom Act requires that “[e]very telecommunications carrier that provides interstate telecommunications services shall contribute, on an equitable and nondiscriminatory basis, to the specific, predictable, and sufficient mechanisms established by the Commission to preserve and advance universal service.”

Today, all telephone companies that provide interstate or international services in the U.S. contribute to the USF on the basis of the proportional “user pays” philosophy. Each telecommunications company’s payment to the USF is proportional to its share of the market for long distance and international calls. These payments are adjusted every quarter based on the projected universal service needs and the projected revenues generated by interstate and international calls.

By law, these assessments are based on the company’s revenues from interstate and international calls, not the phone activity of individual phone customers. Therefore, each company makes a competitive business decision regarding whether and how to assess customers, in order to recover their USF costs.

Wireless service providers have a special provision that is based on a flat rate calculation of estimated total revenues rather than actual revenues generated by interstate telephone calls. A staff study by the FCC estimates that wireless connections will grow by more than 50 million between 2002 and 2007 while land line connections are expected to grow by fewer than six million over the same time period.

Recently, it has been strongly espoused by the “Chicken Little” long distance carriers that major changes are necessary in the collection of universal service funds in order to maintain the fund as "specific, predictable and sufficient." Under proposals put forward by the major long distance carriers and examined by the staff of the FCC, this radical shift in the burden for funding the USF would be accomplished through a new kind of USF assessment.

A new assessment (or "connection tax," lets be honest and call this what it really is!) would be placed directly on consumers simply for the privilege of having a phone. Under this proposal, the proportional "user pays" system would be replaced with a monthly flat rate phone tax on all phone consumers, regardless of how much those individual consumers use their telephones. At the same time, telecommunications companies would see their USF assessments substantially reduced, with no guarantee that these cost savings would be passed back to consumers.

Competitive decisions, now made in the market place, on how much of the responsibility for this assessment should rest with long distance consumers and how much should be absorbed by long distance companies as a cost of doing business would be taken away by FCC fiat with the imposition of a new "connection tax."

As we have found in our examination of this issue, assumptions that fundamental changes are necessary to the revenue-based methodologies currently used to collect funds for the USF are far fetched. Various methodologies used by the FCC staff to predict where the funds for the USF will come from in the next ten years already project significant shifts in the burden of payment among long distance carriers, local exchange carriers, and wireless carriers, primarily because of the predicted growth of wireless phones.

Under the baseline projection for revenue-based methodology the share of contributions by industry segment would shift from 59% for long distance carriers, 26% for local carriers, and 15% for wireless carriers in 2002 to 41%, 32%, and 27% respectively by 2007. Therefore the burdens that the major long distance carriers now complain about will largely resolve themselves as the telecommunications industry evolves naturally to address the dynamic and competitive growth in telephone usage by consumers.

In significant contrast, all baseline projections for "connection tax" methodologies shift an even greater disproportionate share of the USF funding responsibility away from long distance carriers. In 2002 the long distance carriers were responsible for 59% of USF revenues. The three "connection tax" proposals currently under scrutiny at the FCC, demonstrate that their responsibility would fall to 22%, 29%, or 13% respectively. In essence, this gives a free ride to the most lucrative part of the telephone phone business, the long distance service sector. It would also significantly reduce the responsibility of high volume, business users of long distance telephone services to financially support the USF by effectively imposing additional USF charges on intrastate telephone calls. With this shift would come significant shifts in the financial burden on individual consumers, especially in rural areas, with no apparent benefit to consumer populations that are dependent on USF funding to maintain telephone service.

In contrast to a "connection tax", a modified revenue-based methodology is the most reasonable alternative for funding the USF. This approach will result in the fewest disruptions in the long standing relationships among various companies and their consumers and will preserve the competitive aspects of the current assessment system that lets individual companies decide how best to absorb or pass on these assessments to consumers.

In addition to the obvious problems of equity, the proposed "connection tax" simply does not fit the legislative intent of the Telecommunications Act of 1996 or Section 254(d). "Connection taxes" fail to meet the requirement that every telecommunications carrier contribute in an equitable and nondiscriminatory manner to the USF. It is highly likely that imposition of a new "connection tax" by the FCC would result in a strong court challenge by consumer groups and others to test the legality of this scheme, further creating uncertainty in the telephone business marketplace.

If a radical new "connection tax" is not the answer to the temporary revenue problems facing the USF, then what is the answer? In December 2002, the FCC issued an interim rule that crafted modest changes to the current revenue based methodology. The interim rule modified the current revenue base to increase the minimum assessment that wireless carriers pay toward USF charges from 15% to 28.5% of revenues. This change better captures the industry wide proportion of wireless calls that involve long distance service.

However, it is still an imperfect measure of the contribution that the individual wireless carriers make to overall interstate service and therefore should make to the USF. The interim rule also changed the assessment base from "revenues accrued" to "projected revenues" to address concerns by some long distance carriers related to the declining customer base that some carriers are experiencing.

Finally the interim rule prohibits telecommunications carriers from charging customers any "mark-up" above their relevant contribution factor for their USF assessments. These most recent changes are sufficient to maintain the solvency of the USF for several years on a basis that is equitable and nondiscriminatory to the various segments of the telephone industry as well as their end-user customers.

The Universal Service Fund has clearly served as a necessary component in the achievement of parity of telephone services to all segments of the United States. The current revenue-based methodology deserves to be recognized as the most equitable, least discriminatory, and least market intrusive manner in which funds can be collected.

As the recent proposals by the FCC prove, the issues surrounding collection methodology should continue to be examined, and incremental changes should be implemented to correct inefficiencies or inequities. For example, the FCC should move away from "safe harbor assessments" for the wireless carrier industry and replace them with methodologies that accurately reflect each wireless company's proportion of the long distance market. In addition, the allowance of an adequate passage of time between implemented changes is highly recommended, to allow valid observations of the results.

Adopting a new "connection tax" to fund the USF would be a drastic change. Instead the fundamental structure of the current revenue-based methodology for assessing USF contributions, based on the "user pays" principle should be maintained. In addition, the interim changes put in place in December of 2002 should be given a chance to work. Additional modifications to fine-tune the existing revenue-based methodology should be explored to assure equitable and sufficient collection of USF revenues, and equitable distribution of USF fees across various segments of the telephone industry as well as across the various segments of the consumer population, including rural, end-user customers, because, as we learned from the popular children's story, the sky really isn't falling.